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No. 425

IN THE
Supreme Court of the United States

OCTOBER TERM, 1930

GROUP NO. 1 OIL CORPORATION, *Petitioner*,

v.

JAMES W. BASS, COLLECTOR OF INTERNAL REVENUE FOR THE UNITED STATES FOR THE FIRST DISTRICT OF TEXAS, *Respondent*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

PETITION OF THE PETITIONER FOR A REHEARING

Comes now the above named petitioner, Group No. 1 Oil Corporation, and presents this its petition for a rehearing of the above entitled cause, and, in support thereof, respectfully shows:

Preliminary Statement.

In this case petitioner asserts that its income from oil and gas leases granted by the State of Texas is exempt from the Federal income taxes.

This court, in denying it this exemption which, in Gillespie v. Oklahoma, 257 U. S. 501, was accorded

similar Federal lessees as to Oklahoma State taxes, has sought to distinguish Texas leases on the ground that in Texas oil and gas leases are construed as sales; that the title to the minerals has "completely passed" from the State "by a completely executed act of sale, without restriction" and that "no interest in it (the minerals) has been retained for the benefit" of the State. It therefore has said that these minerals are now "a part of the common mass of property and subject to its common burdens," and that a denial of the right of the Federal government to tax the income of the lessee would insure to the State of Texas only a "remote and indirect antecedent benefit." This court further states that these leases are non-distinguishable from the mining claims acquired in lands of the United States which were held subject to State taxation in Forbes v. Gracey, 94 U. S. 762, and that they are subject to this non-discriminatory Federal income tax. The foregoing is a brief summary of the court's opinion, though the same order of its reasoning is not followed.

We submit that the judgment of the Circuit Court of Appeals should have been reversed and that of the District Court affirmed.

I.

The rule that property when sold by one government is taxable by the other is wholly inapplicable.

This Court has so repeatedly stated that the exemption of one government's agencies from taxation by the other is to be determined not by technical rules of law but by a consideration of the real and actual effect of the tax, that its decisions to that effect need not

be further cited. This Court has, however, in this case based its decision entirely on the local Texas construction of the *legal* effect of an oil and gas lease, as interpreted by the Supreme Court of Texas in Theisen v. Robison, 117 Tex. 489. In Texas such a lease is held to convey the title to the minerals in place to the lessee, while the majority of the other States hold the same identical leases confer no such title upon the lessee but merely grant the lessee a license to explore for and produce the minerals when found. Shall the lessees of Texas public lands be held subject to Federal taxation while those of other States are held to be exempt, merely because the Texas Supreme Court has adopted its own peculiar construction of this technical feature of these leases? The burden on both classes of States is the same, and no different rule should be thus invoked against the State of Texas.

This Court has relied on those cases that hold that, where the Federal government has sold lands, they become subject to State taxation. The reasons for holding them to be taxable are wholly lacking in the case of these leases. After the sale the United States has no concern whatever with them or their use. The purchaser and his assignees may use them for any purpose or may let them lie completely idle. No tax upon them can then in any way affect the former government owner. Title to, and all control over, them has completely passed from the government.

At this place we will briefly review the authorities cited by the Court on this point. In New Brunswick v. United States, 276 U. S. 547, the United States Housing Corporation, a Federal government owned corporation, sold a tract and retained a vendor's lien to secure

the purchase price. This Court held the city could tax the purchaser's interest in the land, but could not by any tax sale affect the interest retained by the Housing Corporation to secure its unpaid purchase price. There the United States did not provide how the property was to be used, and the purchaser could let it lie idle if he chose. The purchase price was not to be paid out of any profits or production from the land, but the United States looked only to the land itself. As a result it was of no concern to the United States whether the purchaser was impeded or burdened by State taxes or not. These State leases, however, are granted for the sole and specific purpose of development of the oil and gas, and the State's royalty is wholly dependent upon such production, and any Federal tax upon the lessee's operation of the land directly affects the State through its royalties.

Forbes v. Gracey, 94 U. S. 762, is discussed below.

In Tucker v. Ferguson, 22 Wall. 527, the United States granted to Michigan certain lands to hold in trust to be sold to aid in building a railroad. After the State, in pursuance of the trust, conveyed them to the railroad company and the latter had perfected its right to sell them, the United States had no further interest in the use of the lands, and no State taxes could affect the Federal government. On the other hand, the remarks of this Court at page 572, we submit, support our position, for there it is said that as long as the State held the title for the purposes designated by the United States, the State could not tax them. These State lessees hold the legal title to the minerals for the sole purpose of producing them so that the State may realize upon its royalties, and while they so hold the title for

this purpose, the Federal government may not tax them.

Weston v. Charleston, 2 Pet. 449, 468, simply reiterates the reason why States may tax lands after being sold by the United States is that the latter has no longer any connection therewith and is not interested in any way in the use of the land.

The cases, or cited portions, of Veazie Bank v. Fenno, 8 Wall. 533, 547; Gromer v. Standard Dredging Co., 224 U. S. 362, 371; Choctaw, O. & G. R. Co. v. Mackey, 256 U. S. 531, 537; Central Pacific R. R. v. California, 162 U. S. 91, 125; and Railroad Co. v. Peniston, 18 Wall. 5, 35-37; did not involve taxation of property acquired from the United States at all, but merely held that tangible property of agencies of the United States or parties performing government contracts might be taxed by the States, as, for example, dredging boats and machinery, railroad right-of-way, station grounds, etc. It has long been the settled rule that such property may be taxed.

Turning to these State leases, we find an entirely different situation, and at this point we desire to recall that this Court in its opinion has referred to them as cases in which all interest of the State "has passed to the buyer by a *completely executed act of sale, without restriction,* and no interest has been retained for the benefit" of the State. This is to overlook the essential nature of the leases. The Texas rule simply holds that the legal title to the minerals in place passes temporarily to the lessee for the purpose of producing the minerals and subject to various restrictions and conditions. The Theisen case held these State leases were like the ordinary commercial lease. They pass no absolute

fee title to the lessee. Petitioner's leases are expressly limited to "the purpose of mining, drilling and operating for petroleum or gas."

In Texas Co. v. Davis, 113 Tex. 321, 330, the Court pointed out the limited and restricted nature of the lessee's title:

> "The grant was to become null and void if operations for drilling a well for oil, gas or other minerals were not commenced within two years and prosecuted with due diligence, provided the forfeiture might be prevented by a stipulated yearly payment of money. *The grant was not of an absolute fee. The estate conveyed, on condition subsequent, was a determinable fee,* inasmuch as the land might always produce minerals in paying quantities, causing the grant to endure forever, and inasmuch as the intent is unquestionable that *the land was to be used for no other purpose than to drill for, and produce the minerals, and that the grant was to be enjoyed only while the work of mineral exploration and production was carried on.*"

Again in Robinson v. Jacobs, 113 Tex. 231, 238, the Court said:

> "The intent is as plain from all the terms of the instrument as if it had been expressly declared that the land was to be used for no other purpose than for mineral exploration, development and production, and that on termination of such use nothing should be held or owned under the grant. *Hence, the grant passed no absolute fee. It created a determinable fee,* leaving a possibility of reverter to the grantor or his assigns. *Abandonment of the enterprise, which it was the sole object and purpose of the grant to accomplish, would necessarily end the estate created by the grant.* Stephens County v. Mid-Kansas Oil & Gas Co., decided today, 113 Texas, 160, 254 S. W. 290; 4 Kent's Commentaries, pp. 8, 9; 1 Tiffany's Real Property, 334; 21 C. J., 922."

That the same is true in reference to State leases was pointed out in Greene v. Robison, 117 Tex. 516, 535:

> "A sale or lease by the State is subject to the same rules of law that are applied to ordinary business or commercial leases. In the absence of an express provision, there is an implied covenant for exploration, development, and operation. Freeport Sulphur Co. v. American Sulphur Royalty Co., not yet reported (p. 439 ante, 6 S. W., 2d Series, 1039); and upon abandonment of the property for the purposes of the lease, the oil and gas reverts to the vendor or lessor, as was held in the cases of Grubb v. McAfee, 109 Texas, 527, 212 S. W. 464, and Texas Co. v. Nelson Davis, 113 Texas, 321, 254 S. W. 305."

Thus, these State lessees not only do not obtain an absolute fee to the legal title, but take such title as they receive subject to many restrictions and reservations, among which are: They hold the title solely for the purpose of producing the minerals and not merely to hold the same for future resale; they must use reasonable diligence in developing and operating the properties; they must protect them against drainage by offset wells; they must pay part of the production or the value thereof to the State; they must comply with all regulations of the Land Commissioner with respect to their operations; originally they could not transfer any part of a lease less than the whole, and even now they may not transfer any part thereof in smaller tracts than forty acres. Laws 1925, Ch. 7; Leasing Act of 1925, Ch. 71, Sec. 10. (Brief, p. 106.) A violation of any of these provisions subjects the lease to forfeiture.

This Court has stated in its opinion that these leases are "not distinguishable from the mining claims" on

Federal lands that were held subject to State taxation in Forbes v. Gracey, 94 U. S. 762. We submit the following description of those claims as given at p. 763 of that opinion demonstrates the vast difference between them:

> "It is very true that Congress has, by statutes and by tacit consent, permitted individuals and corporations to dig out and convert to their own use the ores containing the precious metals which are found in the lands belonging to the government, *without exacting or receiving any compensation for those ores, and without requiring the miner to buy or pay for the land.* It has gone further, and recognized the possessory rights of these miners, as ascertained among themselves by the rules which have become the laws of the mining districts as regards mining claims."

From those mining claims the United States received no return, and it cared not whether they were worked or not. Here, however, the State is striving to receive the maximum return from its oil, and if it is not produced diligently, the lease is forfeited.

At this point we desire to point out that Willcuts v. Bunn, 282 U. S. 216, is not analogous. That involved the taxability of profits made on the resale of municipal bonds, and this Court in that opinion, in referring to these oil and gas lessee cases, said at p. 229:

> "These cases are not analogous to the one under consideration."

This Court may have attached some importance to the fact that under the 1917 Act and petitioner's leases the royalty reserved is a fractional part of the value of the proceeds of the oil and gas and not of a part of the minerals themselves. This is immaterial as either pro-

vision amounts substantially to same thing in returns to the State. In fact in the 1925 Act, Ch. 71, Sec. 6 (Brief, 104), and the 1929 Act, Ch. 282, Sec. 5 and 6 (Brief, 116-117), the royalty is a part of the gross production and not of the value of the proceeds. That there is no substantial difference was pointed out in Ehlinger v. Clark, 117 Tex. 547, 563, referred to below.

The State, through these leases, is merely pursuing the ordinary method universally recognized as the proper one for a landowner to follow in converting his minerals into cash. This was forcefully illustrated in Ehlinger v. Clark, *supra*, decided the same day as the Theisen case, in sustaining a lease of county school lands, in which the Court said at p. 562:

> "Under the contract before us, Clark undertook to explore for, capture, and reduce to possession all of the oil beneath the surface of the county's land. It is a matter of common knowledge that this would necessarily entail an enormous expense and a risk which, so far as we know, none of the 248 counties of this State, nor the State itself, has undertaken in the remotest degree. We think that we may also say that *it is a matter of common knowledge of the history of the times that but exceedingly few owners of land have ever undertaken such an enterprise on their own lands.* Exploration and development for oil is a business so hazardous that it is followed in the main only by those engaged in the oil business with enormous resources, or by others who for a speculative purpose join together for such an enterprise. To say that under the broad language of the constitutional provision before us the Commissioners Court of Fayette County was compelled to either enter upon such a hazardous undertaking, for which, in view of the laws of the State we judicially know it had no funds and no authority, or to stand by and permit its valuable oil lands to go undeveloped, or the oil be drained there-

from by its neighbors, because it could not enter *into the ordinary and usual contract for oil development*, is to give this constitutional provision a construction and interpretation not only at utter variance with the broad language used, but one, it seems to us, inconsistent with sound business principles and common sense.

"In other cases disposed of on this day by this Court (but not reported), to wit: Theisen v. Robison (*ante*, p. 489); Greene v. Robison (*ante*, p. 516), and other cases, the statutes, and contracts made pursuant thereto, provided for royalty payments in amounts equal in value to one-eighth of the oil produced. These have been sustained by us in the opinions this day delivered. *We are unable to find any practical difference between the payment made in money, in amount equal to one-eighth of the oil produced, and the actual payment in oil, a commodity which we know is readily convertible into cash.*"

The same has been recognized by this Court, for example, in Von Baumbach v. Sargent Land Company, 242 U. S. 503, 517:

"These lands are situated in Minnesota, and this character of lease has long been familiar in that State, *as a means of securing the development and operation of mining properties.*"

This Court appears to have attached some additional significance to the constitutional provision that the University lands are to be "sold." This provision had no influence on the Texas Supreme Court in holding in the Theisen case that these leases were sales within the meaning of that provision. It so construed them in the light of its interpretation of the ordinary private oil and gas lease. Whether there had been this consti-

tutional provision or not, that Court would have placed the same construction on these leases.

Such being the Texas rule as to all leases, then, if this Court is to adhere to its present holding in this case, the State of Texas, although holding its public domain as the successor to the Republic of Texas and not deraigning title from the United States, and although the United States expressly contracted with the Republic of Texas that the latter might use and enjoy its public lands as it saw fit, may nevertheless not enter "into the ordinary and usual contract" for the development of its oil without being subject to control by the Federal government. To convert its minerals into cash without interference by the United States, it must itself enter into the oil business, an enterprise that is so hazardous that "but exceedingly few owners of land have ever undertaken on their own lands."

These leases are more than sales in the ordinary sense, as in New Brunswick v. United States, *supra*. They are conveyances of the legal title to the minerals in place, subject to many restrictions and qualifications, plus a definite and detailed contract on the part of the lessee concerning the use of the property. We submit that the State retains at all times a vitally important and controlling interest in these properties.

Even if these leases are looked upon simply as sales without regard to their other features, these Federal taxes are a direct impediment on the State in effecting the sales, and the benefit to be derived by the State from the exemption of its lessees or "purchasers" is not a "remote and indirect antecedent benefit." This Court in its opinion recognizes that the sale by the State may not be taxed or controlled by the United States. Now,

in the ordinary sale of government land, the government is not seeking to obtain the highest price obtainable but its primary purpose is to pass government land into private hands. The purchase price is always a definite fixed amount that is payable absolutely and not conditioned upon or measured by what the purchaser may produce from the land. If such lands should not be taxable, the purchaser and his assignees would forever be exempt, while this might induce him to pay more for the land originally, this withdrawal of all such land from State taxation forever would permanently and seriously affect the State in raising revenue while the resulting increase in the purchase price paid would be negligible.

On the other hand the State of Texas is seeking to obtain the maximum amount possible for its minerals. Its sales price is not a fixed cash sum but its amount is dependent on the returns through the royalties. These returns continue as long as the lessee holds title to the minerals, for as soon as he ceases to produce them the title reverts to the State. Any tax by the United States that hinders him in his production directly affects the *current* amount received by the State. If the lessee is not required to pay these income taxes to the United States, he can and will bid a higher royalty to be paid to the State. Furthermore this exemption is not one running indefinitely, as in the case of ordinary lands, but exists only for the limited time the minerals are being produced, for after that title to any minerals remaining reverts to the State.

That the State will receive larger royalties is not a theoretical proposition but is a practical one. We all know States and municipalities are able to borrow

money at a low rate of interest because neither their bonds nor the interest thereon may be taxed by the United States. In the same way the State will receive vastly more from its minerals if its lessees are not subject to the Federal income tax. For example, the tax on corporations for years has been approximately 12% or roughly one-eighth of their net income, while that on individuals, normal and surtax, rises to at least 25%. If a corporate lessee knows it will not have to pay 1/8 of its net income to the United States, it will bid at least from 1/24 to 1/16 additional royalty to the State. This would increase the State's royalty by from 33 1/3% to 50% over the usual one-eighth. In other words if this Court holds that these lessees are exempt, there will never be another lease granted by the State for as low a royalty as one-eighth.

We submit, therefore, that these benefits to the State are not remote or indirect or antecedent, but are direct, continuous and of great practical value.

II.

The local rule in Texas that leases are sales of the minerals in place is not controlling.

In the foregoing remarks we have demonstrated that the question before this Court is not dependent on whether these leases are sales or not, and it is to be answered only by a consideration of the real and substantial effect of the tax. Under this proposition we will consider whether this Court is to decide this and cases that may arise from other States upon the local State construction of similar leases.

The majority of the State courts construe mineral leases as granting the lessee only the license or privilege of going upon the ground and producing the minerals when discovered, and as not conveying any title to the minerals. A few States, notably Pennsylvania and Texas, construe them as sales of the minerals in place. (See Stephens Co. v. Mid-Kansas Oil & Gas Co., 113 Tex. 160, 168, for discussion of Texas and Pennsylvania rule, and Von Baumbach v. Sargent Land Co., 242 U. S. 503, 517, for reference to Pennsylvania).

This Court, when Federal taxes have been involved, has consistently held as its own view, independent of the view of the particular State where the leases involved were located, that such leases are not sales of the minerals.

In Von Baumbach v. Sargent Land Co., 242 U. S. 503, it held that a corporation lessor did not by a lease sell its minerals, and its royalties were income and not proceeds of capital assets, and that it must pay the Federal taxes on that basis.

In United States v. Biwabik Mining Co., 247 U. S. 116, it held that the lessee of a mine did not own the minerals when the Corporation Tax Act of 1909 became effective, and therefore could not deduct their 1909 value from the subsequent sales price in determining the amount of its income, but must compute its tax without this deduction.

In Burkett v. Commissioner, 31 Fed. (2nd), 667 (certiorari denied, 280 U. S. 565), the lessor claimed a cash bonus received for executing an oil lease was the proceeds of the sale of his minerals and subject to the flat 12½% income tax under the sale of capital assets provision in Sec. 206 of the Revenue Act of 1921, but the

court held the lease was not a sale of the minerals and he must pay the higher rate of taxes.

In Berg v. Commissioner, 33 Fed. (2nd) 641 (certiorari denied, 280 U. S. 598), the court held that oil royalties were ordinary income and not proceeds of the sale of capital assets and were taxable as ordinary income and not at the lower rate under said Sec. 206. This was held even though the lease said that the owner "does *grant, convey, demise* and lease" the land for oil and gas production.

In Rosenberger v. McCaughn, 20 Fed. (2nd) 139, 25 Fed. (2nd) 699 (certiorari denied, 278 U. S. 604), the courts held that royalties on a mineral lease in Pennsylvania were not the proceeds of the sale of the minerals and must be taxed as ordinary income. *The courts refused to follow or be bound by the decisions of the Pennsylvania Supreme Court that such leases were sales of the minerals.*

In the analogous case of Burk-Waggoner Oil Assn. v. Hopkins, 269 U. S. 110, the Supreme Court of Texas had refused to adopt the Massachusetts trust theory of unincorporated associations and held them all to be pure partnerships. This Court held the partnership was liable to the Federal income tax on associations, and that it was not bound by the Texas court's holding that it was a mere partnership.

If this Court adheres to its decision in this case, we submit the following results must necessarily follow:

1. Lessees of State lands in those States where leases are construed as only licenses will be exempt from Federal taxes, while lessees of public lands of Texas and similar States will be taxable. There is no substantial reason for this differentiation.

2. Cash bonuses received by private parties on the execution of mineral leases in Texas will be proceeds of the sale of capital assets, and where the minerals have been owned for over two years the lessors may take the flat 12½% tax rate under Section 101 of the 1928 Revenue Act.

3. Royalties on leases in Texas will likewise be the proceeds of the sale of capital assets and taxable at the lessor's option under Section 101.

We do not believe this Court intends to leave these matters to depend upon the local rule of construction in each State, but such is the necessary and inevitable result of its present holding in this case.

III.

The State of Texas has a direct and practical interest in having its lessees exempt from Federal taxes.

This Court has stated these taxes have only a remote and indirect effect upon the State of Texas. We believe the foregoing remarks demonstrate the contrary, and at this point we will refer only to the State's attitude as shown by its actions.

In Willcutts v. Bunn, 282 U. S. 216, the Court had under consideration the taxability of profits derived from the sale of municipal bonds. In that case the States of New York and Massachusetts appeared as *amici curiae* in defense of the tax, and this Court remarked upon that fact as follows:

> "No State has ever appeared at the Bar of this Court to complain of this Federal tax, and it is not without significance that in the present instance the States of New York and Massachusetts do appear here as *amici curiae* in defense of the tax."

In the present case the State of Texas has considered its interests so vitally affected by this case that it has appeared as *amicus curiae* to resist this tax. When this Court on October 20, 1930, denied the application for writ of certiorari and it first appeared that this Court might hold these State lessees were taxable, the State immediately intervened with a brief urging the importance of the question to the State and asked that the writ be granted. After the writ was granted, it filed a further brief on the merits.

So far as we have been able to ascertain, this is the first time that any State has actively intervened with one of its agencies to contest any Federal tax, although the doctrines involved were first announced in 1819 in M'Culloch, 4 Wheat. 316. This action by the State is concrete and substantial evidence that it does not consider these taxes have only a remote and indirect effect upon it.

The State of Texas, through its Attorney General, has thus taken every step that it can to resist these Federal taxes, and thus demonstrates as a practical matter the burden of these taxes on the State itself.

IV.

The decisions of this Court in Gillespie v. Oklahoma, 257 U. S. 501, and the other Oklahoma cases are not distinguishable.

We submit Gillespie v. Oklahoma, *supra*, and the other Oklahoma lessee cases, are controlling. If the Supreme Court of Texas were called upon to construe the leases involved in those cases, it would hold they were likewise sales of the minerals in place. This fact should

not in any way cause this Court to adopt a different rule in this case from that followed in the Gillespie case.

This Court in the latter part of its opinion refers to the Indian lands themselves as being Federal instrumentalities. The State lands involved here are likewise State instrumentalities: (*a*) The first act of any government on discovering a new area is to claim all the land for itself, otherwise it would have no control over the land upon which it proposes to set up its machinery of government. Thus the ownership of public domain is the first act of government. (*b*) The lands here involved have been set aside for the maintenance of a public University. No one questions that public education is an important governmental activity, and the United States in this case does not contend to the contrary. If the Indian lands were Federal instrumentalities for administering the affairs of the Indians, certainly these lands are State instrumentalities for promoting public education.

The respondent at pages 20-22 of his brief seeks to limit these Oklahoma cases by saying they were so decided because tax statutes are to be construed liberally in favor of the Indians. In none of those Oklahoma cases has this Court ever referred to that doctrine as a ground upon which it based those decisions. On the other hand it rejected the argument in Heiner v. Colonial Trust Co., 275 U. S. 232, in holding the same lessees of Indian lands subject to the Federal income tax. Likewise it has cited those cases in numerous others as being leading authorities on the fundamental questions involved. (See Brief, p. 32.)

The Interstate Commerce cases are not applicable as

this Court pointed out in Gillespie v. Oklahoma, 257 U. S. 501, 504.

If, as this Court said, in the Gillespie case the Oklahoma State income tax was "a direct hamper upon the effort of the United States to make the best terms it can for its wards," we submit we are unable to see why the Federal income taxes on these State lessees are not also a direct hamper upon the effort of the State of Texas to make the best terms it can for itself.

Conclusion:

We have not attempted to reply to the respondent's brief, owing to lack of space, but have confined our remarks to the points mentioned in the Court's opinion. We also have not replied to certain arguments of the respondent in reference to Section 27 of the 1917 Leasing Act, which arguments we consider unsound, as we assume from the Court's opinion that it does not construe that section as the Circuit Court of Appeals did.

For the foregoing reasons it is respectfully urged that this petition for a rehearing be granted, and that the judgment of the Circuit Court of Appeals be, upon further consideration, reversed and that of the District Court affirmed.

Respectfully submitted,

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CERTIFICATE OF COUNSEL.

I, Homer L. Bruce, counsel for the above named petitioner, do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for delay.

HOMER L. BRUCE,
Counsel for Petitioner.